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DEPT FOR SCA/FO DAS GASTRIGHT, SCA/RA, SCA/PB AND SCA/A
CENTCOM FOR CG CFC-A
NSC FOR AHARRIMAN
AID FOR ANE/AA MWARD AND SKEYVANSHAD
TREASURY PASS TO LMCDONALD, ABAUKOL, AND JCIORCIARI
OSD FOR BRZEZINSKI

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SUBJECT: U.S.-AFGHANISTAN STRATEGIC PARTNERSHIP
PROSPERITY WORKING GROUP, FEBRUARY 21, 2007

Ref: Kabul 692

SUMMARY

11. (SBU) In the second meeting of the Afghan-U.S. Strategic Partnership Prosperity Working Group, Afghan and USG dels reaffirmed their commitment to a long-term economic partnership and advanced preparations for the March 13-14 Strategic Partnership plenary in Kabul to be co-led by Under Secretaries Burns and Edelman. Both delegations noted that the meeting provided an excellent forum for reviewing joint efforts towards achieving Afghanistan Compact goals. The Afghans made a strong pitch for donor assistance in urgently enhancing Kabul's electricity before the 2009 general elections. USDEL stressed its strong commitment to supporting GOA efforts in the energy sector and indicated its willingness to look at funding additional power generation capacity for Kabul, based on GOA acceptance of key conditionalities (action cable on Kabul electricity follow up has been transmitted refTel). USdel identified an imperative to provide budget support for road maintenance. Both sides agreed that airport planning, operations, and management need urgent attention.

12. (SBU) The Afghans highlighted their concern about the surging recurrent cost obligations from donor spending and ANA/ANP expansion and pay increases. Revenue is not growing as quickly. USdel stressed the need for fiscal discipline and revenue enhancement through improving tax administration and enacting new taxes. The Border Management Initiative could have a large positive impact on customs collections, but the GOA needs to push forward on creation of a Border Management Commission and ensure participation of all ministries with a stake in the issue. USdel agreed to share with the GOA an analysis of customs revenue losses. On development budget execution, the Finance Ministry advised it is moving forward with

program budgeting and provincial budgeting initiatives to create greater flexibility and more effective development project implementation at the province and district levels. USdel noted its willingness to put more resources through the GOA development budget in line with GOA capacity to absorb and manage such funds. US delegation head Ward proposed that our teams discuss two possible pilot projects involving capacity building and concomitant channeling of direct support to the Afghan core budget.

13. (SBU) USdel praised GOA for enacting four commercial laws in January and encouraged the Afghans to move nine other laws to enactment by the end of the year. USdel acknowledged capacity constraints at the Justice Ministry and pledged assistance to alleviate this bottleneck in the legislative process. USdel announced USAID's sponsorship of the first Agricultural Trade Fair, scheduled for April. After a discussion of regulatory bottlenecks for exports, the GOA undertook to announce at the trade fair a specific plan to reduce red tape hampering Afghan exports. In the discussion of Reconstruction Opportunity Zones, the Afghans promised to provide a paper on suitable products and locations and a broader concept paper. On Afghan-Pakistan transit trade, the GoA advised that it offered to host the Joint Economic Commission in Kabul on March 14-15, but Pakistan had not yet responded. The Afghans also indicated that Pakistan had offered to host the next Regional Economic Cooperation Conference (RECC). The illicit finance discussion highlighted the importance of increasing the registration of hawaladars and beginning enforcement of U.N. terrorist lists. The GOA committed to brief

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Strategic Partnership principals on a draft plan to shut down unregistered hawaladars. The two delegations recognized that access to credit is crucial for economic growth, but that the high risk environment, including a recent wave of bank robberies, is constraining the growth of the financial sector. USAID discussed how its new ARIES project would be addressing some of these constraints while providing significant levels of credit. The GOA agreed to take strong steps to improve the security of financial institutions and their assets. Concluding the session, both sides agreed to name focal points and hold regular quarterly meetings at the working level in Kabul.
END SUMMARY.

PROGRESS SINCE MARCH 2006 STRATEGIC PARTNERSHIP TALKS:

14. (SBU) U.S. and Afghan inter-agency delegations held their second Strategic Partnership Prosperity Working Group session in Kabul on February 21, 2007. USDEL was led by USAID Acting Assistant Administrator for Asia and the Near East Mark Ward. He was joined from Washington by State Department South Central Asia Bureau DAS John Gastright, NSC Senior Director Tony Harriman, Treasury South Asia Director Andrew Baukol, USTR Director Robert Gerber, and EB Economic Officer Marybeth Goodman, and supported by embassy staff. The Afghan side was led by Deputy Finance Minister Wahedullah Shahrani. Their delegation also included Central Bank Governor Norullah Delawarie and the head of the bank's Financial Information Unit; Afghan National Development Strategy Director Adib Farhady; and Deputy Minister-level representatives from the Ministries of Commerce and Industry (MoCI), Water and Energy (MoEW), Agriculture (MoA), Ministry of Rural Reconstruction and Development (MRRD), Ministry of Urban Development (MoUD), Ministry of Mines (MoM), and the Ministry of Women's Affairs.

15. (SBU) Also on the Afghan side was Afghan International Chamber of Commerce CEO Hamidullah Farooqi, representing the private sector; a representative of the Civil Service

Commission; and the chief of the Ministry of Interior's Criminal Investigation Unit. During introductory remarks, both sides reaffirmed their commitment to a long-term partnership between Afghanistan and the United States. They stated that, while significant progress has been made (growth of national income, infrastructure improvements, private sector development, etc), much remains to be done in key areas (investment climate, budget, revenue generation, etc). DM Shahrani expressed appreciation to the United States as Afghanistan's most significant international partner. Both delegations noted that the Prosperity Working Group provided a useful forum for reviewing joint efforts to achieve Afghanistan Compact benchmarks.

LEGAL AND REGULATORY FRAMEWORK

¶6. (SBU) ECON Counselor stated that a functioning commercial legal and regulatory framework was critical to investment and job creation and, while commending the recent passage of four commercial laws (arbitration, mediation, corporations, and partnerships), urged continued priority action in this area. DM Shahrani pledged to meet the Afghanistan Compact benchmark by presenting to Parliament by the end of 2007 six additional commercial laws (agencies, contracts, copyrights, patents, standards, and trademarks) and three financial laws (negotiable instruments, secured transactions, and mortgages). These are among a group of 20 priority laws that the government has notified to the

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JCMB. Accepting the GOA's assertion of capacity constraints at the Taqneen (the Justice Ministry's legislative review department), USDel head Mark Ward offered to increase the existing support to build capacity at the Taqneen to facilitate the movement of priority laws. USDEL noted that to meet its Afghanistan Compact benchmark, the GOA also needs to begin working on the drafting and adoption of regulations and procedures to implement these new laws. DM Shahrani advised that draft regulations must be approved by the cabinet, but procedures may be approved by the responsible ministry. Mark Ward advised that a USAID-funded study on the commercial legal framework should be ready within a month.

RURAL DEVELOPMENT/EMPLOYMENT/AGRICULTURE

¶7. (SBU) The Deputy Minister of Reconstruction and Rural Development (MRRD) briefed that the National Solidarity Program (NSP), the flagship of the five ongoing programs under MRRD, has extended the presence of the GOA to approximately 65% of rural communities. The second phase of this program has begun and MRRD hopes to increase coverage to 100% within three years at cost of \$525M. Both sides encouraged the ministries to work through the Community Development Councils, and to engage the private sector at the community level. AIDOFF enumerated USAID assistance to agriculture, stressing its focus on supporting the growth of commercial agriculture and agribusiness. He announced the first Agriculture Trade Fair, to be held in Kabul on April 21-23. He stressed that new USAID programs would be able to support the emerging GOA integrated approach to rural development. The Deputy Minister of Urban Development urged parallel attention to the urban poor and offered to provide documents; Mark Ward requested that the Deputy Minister provide a paper identifying his proposals.

EXPORT DEVELOPMENT

¶8. (SBU) AIDOFF stated that while Afghanistan used to be a significant exporter of numerous products, its economy is now almost completely dependent on imports. In sectors where it still exports, almost all value-adding

takes outside the country. AIDOFF indicated that we believe that, while volume and quality of goods produced in Afghanistan are an issue, the larger problem is regulatory and procedural impediments that increase the risk and cost of exporting. It takes 66 days and approval of seven documents to export a product from Afghanistan. The World Bank recently ranked Afghanistan as 152nd of 175 countries for ease of cross-border trade. DM Shahrani responded that the GoA needs to simplify its procedures and address corruption. DM Reza (Ministry of Commerce and Industry - MoCI) added that there needs to be a clear division of responsibilities between MOCI and Ministry of Finance. The parties agreed to use USAID programs on commercial legal framework and economic governance to support GOA objectives. In addition, DM Shahrani stated that the GOA would present a detailed and specific plan to reduce regulatory impediments and costs for export at the Agriculture Trade Fair on April 21-23. The USG requested a draft at the Principals' meeting in one month.

RECONSTRUCTION OPPORTUNITY ZONES

¶9. (SBU) ECONOFF advised that President Bush proposed the ROZ concept in 2006 as an attempt to promote private sector development and job creation through duty-free imports to the US. With USG support, an Afghan

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delegation recently visited Jordan to observe its successful Qualified Industrial Zone program. The USG will prepare necessary legislation and consult with Congress. Simultaneously, the MOCI will prepare (1) a short paper on suitable products and locations (subsequently provided on 2/23/07), and (2) an ROZ concept paper. Both sides emphasized the need for development of supporting initiatives (trade facilitation, labor rights, infrastructure, matchmaking services, etc.) to make this program work. DM Shahrani stated that he had received assurance in Washington in March 2006 that this program could cover all of Afghanistan's borders, including borders with northern neighbors.

REGIONAL TRADE INTEGRATION

¶10. (SBU) DM Reza (MOCI) advised that it is prepared to table a revised text for a bilateral transit trade agreement with Pakistan at next Afghanistan-Pakistan Joint Economic Committee meeting. He stated that the GOA has proposed that the JEC meet in Kabul on March 14-15; however, Pakistan has not yet accepted the dates. USTR Director indicated that USG will raise transit trade with the GOP and encourage flexibility in the negotiations. He also praised Afghanistan's leadership on regional trade policies in the context of the Regional Economic Cooperation Conference at New Delhi in November. DM Reza noted that Pakistan has agreed to host the next Regional Economic Cooperation Conference.

BUSINESS BUILDING BRIDGES

¶11. (SBU) When dates and delegation composition are finalized, the Embassy will contact the GOA to begin arrangements for the visit.

STRONGER CONTROLS AGAINST ILLICIT FINANCE

¶12. (SBU) The Central Bank's Financial Intelligence Unit (FIU) Director said that since 2006, the FIU has been receiving monthly reports and suspicious transaction reports from the 14 commercial banks. The Central Bank has begun registering hawaladars and requiring travelers at Kabul International Airport to provide a declaration of cash being carried. Currently, only 30 of approximately 280 hawaladars in Kabul are registered. A

January raid of an unlicensed hawaladar induced a brief upsurge in registration. The Central Bank will increase registration of hawaladars, spread implementation of border cash controls, and report on progress to next Strategic Partnership Prosperity Working Group meeting. USDel Lead Mark Ward requested that the GOA provide a draft plan to shut down illegal hawaladars at the upcoming plenary session. Deputy ECON Counselor stressed the importance of working with banks to identify and freeze accounts of entities on the UNSCR 1267 terrorist list. Embassy Treasury Attache advised that it will continue to sustain technical assistance to the FIU and Bank Supervision Department.

INCREASING ACCESS TO CREDIT

¶13. (SBU) AIDOFF stated that access to credit on a commercial basis is a major impediment to investment and job creation in Afghanistan. Banks that are willing to make loans are charging prohibitive interest rates (20%), while the banks that maintain lower rates lend only on a very narrow relational basis. Various credit and microfinance programs have provided some assistance but cannot substitute for a functional banking sector.

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AIDOFF made clear that perceptions of high risk are the foundation for high interest rates. To address institutional sources of risk, AIDOFF identified four priority reforms of (1) legal and regulatory framework for recovery of assets, (2) credit information system, (3) international reporting, accounting, and auditing standards, and (4) better training for banks that would have a positive impact on the market. Deputy ECON Counselor noted that risk from crime is a growing concern; there have been six major bank robberies (cash in transit) in Kabul in six months. Further thefts could lead insurers to cancel policies and force banks to depart the country (one insurer has declined to renew one bank's policy). To address the risk associated with theft, the GOA agreed to take strong steps to insure the security of financial institutions and their assets.

ROADS AND AIRPORTS

¶14. (SBU) Some 1600 km of the 2500 km ring road has been completed. Donors and the GoA have spent some \$1.5 billion on this road and border connector roads, and are adding another 1,000 km of roads each year, including secondary and tertiary roads. To protect this investment, Deputy Minister of Public Works Rasooli stressed that the GoA will have to spend \$30 million per year on maintenance. By 2017, the ministry estimates that road maintenance costs will rise to \$50-80 million. USAID's Mark Ward said that USAID's original road construction plan included funding for maintenance for several years, but that this money had been diverted to build roads in response to urgent needs, including the insurgency. Ward suggested linking the labor-intensive road maintenance with counter-narcotics resources, because road repairs would employ young men and provide income in rural areas. Ward discouraged the GoA from expecting US help in building the 800 km east-west road directly from Herat to Kabul via Ghor and Bamyan provinces, estimated to cost some \$500 million. Rasooli said the GoA is seeking donors for this new road to handle some of the high volume of truck traffic on the Kabul-Kandahar-Herat segments of the ring road. Truck traffic between Kabul and Kandahar is said to be averaging 12,000 trucks per day. The road was designed to handle only 7,000 per day.

¶15. (SBU) On civil aviation, Deputy Minister of Transportation Alami briefed that Japan will spend \$27 million and the GOA \$8 million to construct a new international terminal for Kabul International Airport.

The project will be completed in 2-3 years. In addition, the ADB has provided \$35 million for rehabilitation of 7 regional airports. The FAA advisor to the GOA added that there was a pressing need for capacity building in the Ministry. He referred to budget coordination problems but said that the dialogue between the Ministries of Transportation and Finance had improved in recent months. One of the challenges he highlighted was the transition over time of the management of airports and airspace from ISAF to the civilian authorities.

POWER SUPPLY

¶16. (SBU) The Afghan delegation made a strong pitch for donor assistance in enhancing the supply of power to Kabul. Deputy Minister of Energy and Water Mir Sediq noted that the Energy Sector Master Plan for Kabul envisions a demand of 950 MW. Currently, he said Afghanistan has an immediate need for over 300 MW to provide lighting alone to those already on the grid. Sediq pleaded for donor assistance in standing up 200 MW

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of new power immediately. In this connection, he drew attention to the high diesel requirements ? 310,000 liters per day -- of the old generators at the North West Kabul Power plant. Shahrani said that \$34 million had been included in the budget for this diesel fuel, with the remainder to come from the national power company's tariff collections, but noted that fuel costs will remain a challenge for the budget. ANDS official Farhadi underscored the political imperative of increasing the power supply in Kabul in the near term, particularly in light of the election timetable for 2009.

¶17. (SBU) Sediq pointed to some missing pieces in NEPS, including funding for a dispatch center and for some substations. He highlighted the urgency of upgrading the distribution network in Kabul. He also mentioned the proposed Sheberghan gas fire power plant as an important project on the horizon and he urged greater attention to renewable energy by the GOA and the donor community. Shahrani provided a brief read-out of the commercialization of the public utility Da Afghanistan Breshna Moassessa (DABM), emphasizing the need to set strong benchmarks, reduce leakages and put in place a modern management system and a trained work force. Sediq reminded Shahrani that progress on DABM commercialization was being delayed by the failure of the Finance Ministry to approve some rules and procedures for privatization of state-owned enterprises. DM Shahrani promised to sort things out.

¶18. (SBU) USAID Mission Director Waskin reiterated the strong USG commitment to supporting GOA efforts in the energy sector. He congratulated the GOA on the formation of the Inter-Ministerial Commission on Energy (ICE) as a coordinating agency and on its decision to raise power tariffs, which underscores the importance of cost recovery. Acknowledging the urgent need that the GOA has identified for additional power in Kabul, Waskin signaled USG willingness to assist with funding and technical assistance if the GOA would step up to the table with certain commitments:

- identify GOA funds quickly to contribute to the capital costs for additional generator sets for Kabul;
- budget for fuel costs and operations and maintenance for the additional generation equipment;
- accelerate DABM commercialization, including outsourcing of metering, billing and collection in Kabul;
- appoint a NEPS coordinator; and
- work with USG support to establish a legal and regulatory framework to attract Independent Power Producers.

¶19. (SBU) Sharani asked for U.S. assistance in exploring

technical and financing options for enhancing Kabul power. USAID Director Waskin reported that USAID had already tasked its contractor Black and Veatch to look at technical options for increased generating capacity for the city.

BUDGET EXECUTION, FLEXIBILITY, AND SUSTAINABILITY

¶20. (SBU) DM Shahrani outlined the fiscal pressures GOA is experiencing due to increasing security (e.g., ANA and ANP) and some non-security (e.g., teachers) expenditures. The IMF agreement allows for increased security expenditures (beyond the 1386 operational budget envelope agreed with the IMF) only if they are donor funded or revenues are increased proportionately. He noted the significant expenditures paid through the external budget that GOA will eventually have to pick up (e.g., U.S. funding of the National Directorate of Security is

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scheduled to end in September 2008). Fuel for Kabul power is another area of budgetary pressure. Only \$34 million is included in the 1386 budget, but the IMF agreed that if MOD fails to meet its ANA recruitment targets, unspent funds from the ANA salary budget could be used to pay for fuel for electricity generation.

¶21. (SBU) MOF Director General for Budget Mastoor described their work earlier in the 1386 budget process with line ministries, provincial level governments, and international donors (through the ANDS working and consultative groups) to prepare a more professional and rationalized budget for 1386. The budget also establishes a better link with the ANDS process; the MOF budget department has been reorganized along ANDS sectoral lines. Two useful pilot projects were created to develop and improve provincial and programmatic budgeting. In 1386, the provincial budgeting program will be extended from three provinces to ten. Dr. Mastoor referenced the new budget mechanism to provide flexibility in implementation of the development budget. The goal is to make the process among ministries more competitive and reduce the type of project ?wish lists? that have been produced by ministries in the past.

¶22. (SBU) In the discussion on improved development budget execution and expenditure management, USAID Program Officer highlighted USAID?s Afghan?s Building Capacity program and the plans to target specific ministries for capacity building. Consistent with USAID?s aid effectiveness policy statement from the London Conference, AID noted it will put more resources through the GOA budget and national programs in line with GOA capacity to absorb and manage such funds. By the time of plenary, USDel Head Mark Ward agreed the US and GOA should identify ministries as part of a pilot that in addition to capacity building would involve the direct disbursement of USAID funds into the GoA core development budget for agreed purposes.

¶23. (SBU) US Treasury Official Andrew Baukol led the exchange on fiscal discipline and managing recurrent costs, and increasing budget flexibility to meet unexpected future needs. He commended GOA for making the budget process more professional. He noted the medium-term sustainability challenge which the U.S. is trying to help GOA meet by providing earlier notice about US funded programs that GOA will have to cover. He emphasized the importance of civil service reform and the good balancing act GOA has done under the IMF program constraints. Deputy Minister Shahrani said he is determined not to seek a waiver to the Compact benchmark on GOA funding 58% of recurrent costs with revenues by 2010-11.

¶24. (SBU) The session on revenue generation focused on the Border Management Initiative (BMI), and improving the

tax regime to meet Afghan Compact revenue targets. The Embassy's Afghanistan Reconstruction Group (Ed Smith) emphasized the cross-cutting nature of BMI and the need for the Ministries of Interior and Commerce to be more active participants. The U.S. will work with the MOF to accelerate the BMI work and push for a GOA inter-ministerial Border Management Commission. The MOF Director General for Customs Ahmad agreed that BMI could help customs expand revenue collection, but described the substantial challenges. There are at least 74 illegal border points, while BMI intends to support 14 official border crossings. When the customs collection capacity has increased (e.g., Herat), traders and importers go to less developed crossings (e.g., Farah).

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¶25. (SBU) Deputy Minister Shahrani said the revenue goal for 1386 is \$715 million, which is also in the IMF agreement, but this is not an increase that is proportionate with increasing expenditures. The Director General for Customs suggested that revenue goals should be given to line ministries, not only MOF. Shahrani asked the US to help calculate how much potential customs revenue GOA loses each year, which would assist them in reducing leakages. We agreed to help in this area. Director General for Revenue Jalali outlined his efforts on non-customs revenues, adding that they have drafted a tax policy paper on which they would welcome comments. MOF has created a large taxpayers office and is expanding this into the provinces. There are currently four major taxes (business receipts tax, wage withholding tax, sales withholding tax, and corporate income tax). Baukol discussed the 3 main ways for GOA to boost revenues: customs, tax administration, and tax policy. The latter may be the best option given the GOA's limited capacity. The elimination of nuisance taxes is a good step, and the creation of a generalized consumption tax will be important for the medium term. Jalali replied that they plan to present to Parliament a broad-based consumption tax by the end of 1387. Shahrani said he supports an aggressive approach to tax reforms, but not necessarily new taxes.

¶26. (SBU) During concluding remarks, both sides agreed to a robust follow-up mechanism, including naming focal points and holding regular quarterly working group meetings at the in Kabul.

¶27. (SBU) COMMENT: The Economic Working Group was notable for its constructive and open discussion of concrete issues and projects, as well as the impressive preparation on the Afghan side led by the Finance Ministry. Key issues requiring further attention during the March 13-14 Strategic Partnership plenary include USG responsiveness on Kabul electricity needs; efforts to strengthen Afghan customs and revenue generation including by bolstering the Border Management Initiative; and further impetus to building capacity in the Afghan government in project development, budgeting, and legislative work.

NEUMANN